

FOMC Briefing
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February 8, 1983

Two rather unexpected developments stemming from the recent introduction of money market deposit accounts and super-NOWs have implications for the long-run monetary targets to be considered for 1983. One unexpected development has been the extreme rapidity and large size of the reaction to the availability of MMDAs, coupled with a somewhat larger portion of these funds than might have been anticipated coming from non-M2 sources--and explained in part by the aggressive initial pricing of MMDAs by banks and other depository institutions in an effort to regain or retain market shares. The second has been the apparently minor involvement of M1 in these shifts.

These developments, for one thing, seem to make it virtually impossible to retain the tentative 6 to 9 percent M2 target range covering the period from QIV '82 to QIV '83 established at the July '82 meeting. In the bluebook, making what we hope are not unreasonable assumptions about future shifts into MMDAs (and we assume some continuation throughout the year but at a considerably slower pace), we translated the 6 to 9 percent into a 9 to 13 percent range. We would expect actual growth most likely to be in the upper half of that range, assuming growth abstracting from shifts of just over 8 percent for the year, and shifts adding about 3 to 4 percentage points. If in an effort to put the bulk of the shifts behind, the FOMC shifted the base for M2 to the February-March period, as suggested in the draft directive, it would still be risky to retain a 6 to 9 percent range, assuming an 8 percent underlying growth in M2 starting now. Our estimate of the shifts adds about one percentage point to the 8, so that the 9 percent upper limit has little flexibility in it.

A first-quarter base would more clearly require a higher range in part because the shifts that occurred early this year would not be as fully captured in the base for the growth rate.

What underlying growth for M2 is reasonable for 1983 is of course a basic issue for the Committee, although there is a genuine question about whether one can see through the ongoing institutional changes sufficiently to permit such an abstract concept to be measured with any real certainty. As Jim mentioned, we have assumed an "underlying" 8 percent for M2 from here on in making GNP forecasts. This presumes that--abstracting from shifts--the sharp drop in income velocity of M2 of last year is not repeated. Our assumption implies a slight decline in underlying velocity, not out of line with a view that the availability of market rates on key M2 components will work to keep growth in that aggregate over several quarters fairly closely in line with GNP. However, in light of last year's experience with velocity, it would not seem unreasonable to set an upper limit for the M2 range that provides some room for the possibility that money demand may continue to be stronger than normal in relation to income. The lower part of the range does provide scope for a reversal of last year's strong demand for liquidity relative to income should that develop out of the more stable financial and economic environment that is presumed at this point to be ahead.

The arguments for some continuing strength in basic money demand can also be made with respect to M1. The relatively minor involvement of M1 in recent shifts tends to make it a bit more plausible to consider stipulating an M1 range for 1983. If the Committee were to take such an approach at this time, that need not of course necessarily involve restoring M1 to clear primacy of place as a guide to short-run open market operations, but the public's perception would surely be that M1 had once

again become important and there would be a need somehow to indicate its degree of importance.

The difficulties of interpreting M1 as NOW accounts, which combine transactions and savings features, increasingly become a more important component of the aggregate argue for relying less strongly on its behavior than in the past. At least for 1983, uncertainties of interpretation, including questions about velocity raised by last year's unusual behavior, also argue for setting a relatively wide range, if a range is to be given. A range with an upper limit of a couple of points above the $2\frac{1}{2}$ to $5\frac{1}{2}$ percent range for 1982 would still imply slower actual growth than last year. It would also allow for a much slower increase this year in the income velocity of M1 than historical patterns would suggest. A slower than average velocity rise this year may be most likely if short-term interest rates stay around current levels, as we have projected, keeping the interest rate loss from placing savings funds in NOW accounts (other than super-NOWs) small relative to market instruments, and if super-NOWs are to show any particular growth.

The monetary range which appears most susceptible to a reduction for 1983 relative to 1982 is that for M3. Reducing that range might not be consistent with institutional developments in the degree that banks and thrifts take advantage of MMDAs sharply to increase their share of total credit flows. However, we have assumed a relatively moderate increase in depository institutions' share of total credit this year, which leaves their share well below average experience of the past thirty years, and appears consistent with continued efforts this year by businesses to rely heavily on longer-term borrowing, rather than bank credit, to strengthen balance sheet positions. Moreover, some of the increase in depository

institutions' share of credit would also come at the expense of money market funds, an offsetting factor in measurement of M3.

We have presented a total credit range, measured by domestic nonfinancial debt, for the Committee's consideration. The range centers on 9-1/2 percent growth, about the same as last year, and the suggested width of the range is consistent with the standard deviation in this growth rate over the past decade. The credit figures were developed out of the flow of funds accounts consistent with our GNP projection. As with the monetary aggregates, the credit figure does also imply a weaker behavior of velocity--the ratio of GNP to debt--than might be expected in a cyclical recovery. In part this may mirror expected asset behavior; it also seems to reflect a relatively weak internal cash flow for businesses, which are not therefore in a position to restrain borrowing as much as usual.

On balance, Mr. Chairman, it is hard to see a case for reducing annual monetary and credit growth ranges for 1983 relative to 1982 (except possibly for M3) unless one were to expect a very sharp reversal of last year's liquidity behavior. Institutional changes in process, and that have cumulated over time, appear to militate against a sharp reversal, accompanied by a substantial rise in velocity. While on the other hand it seems quite doubtful that velocity will be as weak as last year, there is enough prospect of a degree of weakness relative to historical patterns to suggest consideration of the need to raise the upper limits of some ranges. However, if that were done, the institutional basis for change would need to be carefully explained to minimize the odds that any increase in ranges would heighten existing fears that the large prospective budgetary deficits are going to prove to be inflationary because of accompanying monetary expansion.

NOTES FOR FOMC MEETING
FEBRUARY 8-9, 1983
PETER D. STERNLIGHT

Desk operations since the December 21 meeting have been aimed at maintaining an approximately steady degree of pressure on bank reserve availability, while monetary measures were subject to unusual flows because of new deposit accounts. Growth in the broad monetary aggregates turned out to be quite moderate in December, but there was a huge expansion in January, especially in M2, far above earlier anticipations. The massive growth in M2 reflected large flows of funds into newly authorized money market deposit accounts, starting in mid-December, as financial institutions competed aggressively for market share in these ceiling-free accounts. It seemed clear that a sizable part of the M2 bulge reflected redistribution of liquid asset holdings rather than fresh money and credit creation. M3 also showed sizable growth, although pale alongside M2, as banks permitted CD obligations to run off.

Against this background, and in line with Committee decisions in December, supplemented by conference call discussions in January, reserve paths were readjusted through the period to maintain a reserve gap of \$200 million to be met at the discount window. A borrowing gap of that size would ordinarily be associated with Federal funds trading close to the 8 1/2 percent discount rate, and this did in fact emerge in the last few weeks of the period. In the late December and early January weeks, however, there were

seasonal money market pressures compounded by heavy demands for excess reserves and late-in-the-week reserve shortfalls that produced higher than intended borrowing levels and funds trading over 10 percent at times. The financial markets took these unintended pressures around year-end pretty much in stride, with little or no thought that the System was deliberately curtailing reserve availability. Once past the year-end period, the four weeks from January 6 to February 2, borrowing averaged about \$240 million and weekly average funds rates were within a few basis points of 8 1/2 percent. (In the last two full weeks, borrowing averaged about \$150 million.) So far this week, borrowing averages about \$110 million while funds average 8 1/2 percent. Excess reserves have continued to run higher than normal, although it's interesting to note that subsequent data revisions and reserve adjustments have pared down the earlier excesses from the levels reported initially.

Over the intermeeting interval, Desk operations drained a large amount of reserves through sales and redemptions of about \$5 billion of Treasury bills, including \$3.6 billion in sales to foreign accounts and \$1.4 billion of redemptions. These reductions served to offset the release of reserves produced by seasonal return flows of currency from circulation after Christmas, compounded by declines in required reserves as a result of regulatory changes, seasonal deposit declines, and paydowns of large CDs. Frequently, though, it was necessary to intersperse the outright sales or

redemptions with temporary injections of reserves through arranging System or foreign account repurchase agreements. This was done, for example, to cope with temporary enlargements of the pool of foreign repurchase orders, or to deal with occasional day-to-day reserve shortfalls. On just one occasion, the Desk absorbed reserves temporarily through matched sale-purchase transactions in the market.

Incidentally, during the full calendar year 1982, the System's outright holdings of Treasury and agency securities increased by about \$8 billion, or about \$10 billion if you include repurchase agreements. The \$10 billion figure was about equal to the rise in currency in circulation over the year, with other factors roughly offsetting.

Interest rate changes were modest in size and mixed in direction over the interval since the last meeting, responding to a variety of influences. Most short-term rates tended downward after getting past the period of year-end pressures, partly responding to lower Federal funds rates and fairly widespread expectations of another discount rate cut. In the last couple of weeks, however, short rates have backed up, in some cases returning to levels as high or higher than at the time of the last meeting. In part this reflected dwindling anticipations of another discount rate cut--or more generally an expectation that a reviving economy is less likely to see further rate reductions and may encounter increases instead. In addition, market supplies have been a factor in some cases.

Treasury bills, for example, are higher in yield now than at the time of the December meeting. Three- and six-month bills were auctioned on Monday at 8.25 and 8.35 percent, compared with 7.86 and 8.10 percent just before the last meeting and lower rates than that in mid-January. Unremitting Treasury additions to weekly and monthly bills have more than offset some maturities of cash management bills, while the drop in the System's bill holdings also augmented supplies. Rates on bank CDs ended the period with little net change--slightly lower for very short maturities and higher for the longer maturities--while total supplies contracted. Banks cut their prime rate by 1/2 percentage point to 11 percent in early January, but there seems little expectation of another reduction soon.

Yields increased for most intermediate and longer term issues, especially in the latter weeks of the period as most market participants gave up anticipating a discount rate cut and focussed more on the huge Treasury deficits and signs of a developing business recovery. Reports of moderate money growth in December were reassuring, but renewed growth in January generated some concern--even though such concern was tempered by the realization that major redistribution flows are distorting the usual measures. Rates on intermediate term Treasury issues rose about 10-25 basis points while the over 10-year rates pushed up more like 25-35 basis points. The Treasury raised some \$20 billion through sales of coupon issues--including about \$9 billion in the refunding issues

sold last week. Comparing the auction rates of those 3, 10 and 30-year issues with the similar maturities three months--and two discount rate cuts--earlier, the recent rates were higher by 12, 44 and 55 basis points. The market is still working to digest these issues, with all three trading this morning a bit under issue price.

Yields on corporate issues rose more modestly than on Treasuries. Offerings were light around year-end, and only moderate after the new year began, probably reflecting a combination of unreceptive markets and lack of great urgency from the issuers' side. Tax-exempt yields, on the other hand, came down noticeably after year-end, as new issuance abated with the ending of the rush to market definitive securities before year-end. The date for requiring issues to be in registered form has now been moved to July 1, so perhaps we can anticipate another mad rush of bearer form bonds just before mid-year.

NOTES FOR FOMC MEETING

February 8-9, 1983

Sam Y. Cross

At the beginning of 1983 the dollar appeared to be firmly established on an extended downward trend, a downward trend that had begun in mid-November when the exchange market was particularly attentive to our declining interest rates and to our emerging very large trade and current account deficits and widely reported upward revisions in those deficits.

But in mid-January, the situation changed abruptly. The dollar rebounded sharply, rose about 6 to 7 percent against the major creditor currencies, recovering about half of the earlier decline. The rebound reflected a shift in interest rate expectations when the discount rate failed to fall further and the conviction spread that U.S. interest rates might rise. Attention focused on the first signs of economic recovery, and most importantly on the prospect of huge budget deficits without evidence of a political consensus on how to deal with those deficits. The shift in the interest rate environment overshadowed other factors, including concern about the current account deficit even though the prospects of serious balance of payments deterioration remained.

Technically the dollar had been oversold, and the rebound after mid-January was reinforced several times at progressively higher levels as market participants moved to cover short dollar positions which had been established since mid-November. Our data on the foreign exchange position of banks, and on the much higher levels of trading and of large open positions in the foreign currency futures markets seem to be consistent with a

covering of short positions at that time. The markets in January were often characterized as volatile and choppy, and our measures of daily volatility showed some increase in January.

There was much less official intervention on a net basis than in previous months. Partly this reflected less pressure within the EMS, as the market judged that no realignment would occur prior to the French and German elections in early March. Partly the lower intervention may have reflected a German interest not to be influencing the rate too much before the elections. But the dollar's rise was seen by others as essentially a dollar phenomenon, and there was little resistance to that rise through intervention, even though the exchange rate was a constraint to easing of monetary conditions in other countries, and apparently delayed or forestalled such moves.

More recently the dollar has been moving up and down within a rather broad trading range. In terms of the German mark, the range seems to be from about 2.40 to about 2.48. Within that range there are a lot of transitory movements seemingly related to day-to-day shifts on interest rates and other political and economic factors.

FOMC RECOMMENDATIONS

Since the last meeting of the Committee, the Bank of Mexico was granted five drawings totaling \$320 million on its combined \$1.85 billion BIS-U.S. special credit facility, leaving \$140 million still available in that facility. The Mexican authorities were also granted three-month renewals of five earlier drawings totaling \$586.9 million. The Bank of Mexico repaid \$327 million of its \$700 million drawing on the regular Federal Reserve swap line using the proceeds of its first drawings under the IMF agreement. On February 3 it was agreed that the Federal Reserve would extend until February 28 the remaining \$373 million outstanding on this line, which had been scheduled to mature on February 4.

Mr. Chairman, swap drawings totaling \$142.2 billion by Mexico under the Federal Reserve special swap arrangement will mature between now and April 8, 1983. Of these, six drawings totaling \$61.2 million will come up for their first renewal and seven drawings totaling \$81.0 million for the second renewal. I would proposed that all of these drawings be extended for three more months. You will recall that all drawings on this facility are subject to three renewals of three months each and are to be liquidated by August 23, 1983.